



Treasury Trends

Bringing currency to the Arizona Taxpayer

David A. Petersen, State Treasurer

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This month's character trait ---

Forgiveness:

Clearing the record of those who have wronged me and not holding a grudge

Both LGIP Pools continue to increase their yields in January 2005

LGIP Core Pools now available

LGIP Performance

The Board of Investment, in the regular meeting held on February 16, 2005, was informed of the performance of the LGIP and LGIP-Gov pools. Both pools continued to increase their yields over the previous month. Balances of the pools also remained relatively stable for the month.

Yields		LGIP	FYTD	WAM	LGIP-GOV	FYTD	WAM
Pool size →		\$3.0 B			\$1.3 B		
January	'05	2.30	1.95	100.32	1.92	1.60	141.59
Feb	'04	1.44	1.46	80.30	1.00	1.04	118.86
March	'04	1.39	1.45	79.00	1.01	1.03	116.59
April	'04	1.39	1.45	82.66	1.02	1.03	151.44
May	'04	1.39	1.44	79.30	1.01	1.03	129.30
June	'04	1.45	1.44	71.59	1.06	1.03	122.64
July	'04	1.59	1.59	180.85	1.25	1.25	137.49
August	'04	1.72	1.65	167.22	1.39	1.32	116.82
September	'04	1.81	1.71	162.99	1.45	1.36	113.7
October	'04	1.90	1.76	151.52	1.57	1.41	101.86
November	'04	2.06	1.82	151.65	1.72	1.48	88.66
December	'04	2.21	1.89	145.53	1.80	1.54	79.27

Fiscal Year is July 1 to June 30

New Pools Up and Available for Investment

As the late George Peppard's character, Colonel John "Hannibal" Smith, in the old TV show "The A Team" used to say, "I love it when a plan comes together." In the last legislative session, the Arizona Treasurer's Office was authorized to open two new pools for local government investment purposes. This was in response to requests from LGIP participants wanting to be able to customize portfolios to better meet longer duration needs. These two new pools posed some challenges. Due to the longer duration of these pools, it was necessary for them to have fluctuating net asset values (NAVs). Linda Willis and her investment accounting team spent numerous hours in evaluating and developing the processes to provide accurate calculations and maintain the level of service to which LGIP members have become accustomed.

Effective February 1, 2005, Pools 500 and 700 became available for investment by LGIP participants. Pool 500 (LGIP Core-Mix) is a longer duration version of Pool 5 (LGIP). Pool 700 (LGIP Core-GOV) is a longer duration version of Pool 7 (LGIP-GOV). Both these core pools have a duration target of about 2 1/2 years.

Overlap: Unintended Consequence

Diversification among assets and asset classes is a generally accepted method to reduce risk. However, some types of diversification actually INCREASE risk. For example, two portfolio managers are hired to manage pools within the same asset class. What happens? Unless someone is watching the two managers very closely, they may end up buying the same assets. Is this a problem? Yes. A portfolio may end up with greater concentration of one particular asset than is actually prudent. In essence, the portfolio ends up with greater concentration, rather than greater diversification. This concentration effect is called "overlap." In short, the holdings of one portfolio manager overlap the holdings of another, causing a reduction in diversification.

Overlap is the unintended consequence of buying into the argument of diversification through multiple managers

Some asset managers have used the faulty logic that is wise to utilize the services of multiple asset managers as a form of diversification. This argument is usually promoted when a potentially "new" manager is trying to take assets away from an existing mandate. For example, XYZ management is managing \$100 Million in short-term diversified bonds for a client. ABC Asset Gatherers wants to get their foot in the door so uses the "diversification among managers" idea. While on the surface this concept seems to have merit, unfortunately, multiple managers in the same asset class almost inevitably leads to some overlap. If an investment policy limits concentration or exposure in certain asset types, utilizing multiple managers may actually cause a violation of the investment policy. So how is this problem avoided?

- (1) Assign someone in your organization to review each manager's holdings and identify positions which overlap. Then, verify the overlap does not exceed restrictions in the investment policy. This requires continuous review of buys and sells and coordinating communication between managers. It also requires mediation when multiple managers want to buy the same asset. Who gets to buy what and how much? If managers are restricted in their decisions, does this then give them an excuse for sub-par performance?
- (2) Eliminate concentration restrictions in the investment policy.
- (3) Simply use one asset manager per asset class.

While the siren song of "diversification through multiple managers" seems appealing, the unintended consequences of "overlap" may leave financial officers marooned on the rocky shoals of compliance and concentration.

***LGIP: local & state government working together
to safeguard Arizona taxpayers' money.***

David A. Petersen
Arizona Treasurer
1700 W. Washington
Phoenix, AZ 85007

Phone:
(602) 604-7800

Fax:
(602) 542 -7176

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www.aztreasury.gov

Yield Curve Perspective

Treasury Yield Curve				
Term	25 Feb	1 Week Earlier	1 Month Earlier	1 Year Earlier
3 mo.	2.74	2.59	2.41	0.96
6 mo.	2.94	2.89	2.70	1.01
2 yr.	3.52	3.44	3.21	1.60
3 yr.	3.66	3.60	3.37	2.14
5 yr.	3.89	3.87	3.71	2.97
10 yr.	4.26	4.27	4.19	4.01
30 yr.	4.63	4.65	4.68	4.89